Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [redacted]:TL-N-1147-99
[redacted]

date: APR 0 3 1999

to: Chief, Examination Division, [redacted] District
Attn: William Kennedy

from: District Counsel, [redacted] District, [redacted]

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subject: [redacted]
Request for Advice - [redacted] Contract

DISCLOSURE STATEMENT

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This memorandum is in response to your request for preliminary advice concerning the classification of certain expenses incurred by [redacted] under the [redacted] Contract. You requested that we furnish preliminary legal advice on this issue, prior to factual development, solely to provide some initial guidance to the examining agent in the conduct of the audit. This response should only be considered as an aid in identifying potential issues for further development. As the facts surrounding this potential issue have not been developed, we can only provide you with a discussion of

potentially relevant legal considerations and make recommendations regarding factual development. Accordingly, we are not providing any opinion with respect to your request. However, we have supplied a discussion, to the extent possible, based on the information furnished and pointed out the areas in which additional factual development is required.

ISSUE

Whether expenses incurred under the [redacted] Contract should be aggregated with expenses of the [redacted] Contract to prevent the unreasonable deferral of recognition of income.

FACTS

[redacted] Motorola, Inc. and its wholly owned subsidiary, [redacted], entered into the [redacted] Contract ([redacted]) on [redacted]. [redacted] was to receive a license to [redacted] and [redacted].

[redacted] ([redacted]) and [redacted] ([redacted]) entered into the [redacted] ([redacted]) contract on either [redacted] or [redacted]. This contract was for the construction of [redacted].

The [redacted] constructed under the [redacted] contract would [redacted] contract.

DISCUSSION

I.R.C. § 460 provides the accounting rules for long-term contracts entered into after February 28, 1986. Under section 460(f), a long-term contract is generally defined as any contract for the manufacture, building, installation, or construction of property that is not completed within the tax year the contract is entered into. Section 460 generally requires the percentage of completion method or the percentage of completion - capitalized cost method to be used for long-term contracts entered into after February 28, 1986, for regular income tax purposes.

I.R.C. § 460(c)(1) of the Code provides that, in the case of a long-term contract, all costs (including research and experimental costs) that directly benefit, or are incurred by reason of, the long-term contract activities of the taxpayer, shall be allocated to such contract in the same manner as costs

are allocated to extended period long-term contracts under section 451 and the regulations thereunder.

Treas. Reg. § 1.451-3(a)(3) states that the term "expenses attributable" to long-term contracts means all direct labor costs and direct material costs (within the meaning of paragraph (d)(5)(i) or (6)(i) of this section), and all indirect costs except those described in paragraph (d)(5)(iii) or, in the case of extended period long-term contracts, paragraph (d)(6)(iii).

The definition of a long-term contract in section 1.451-3(b)(1) of the regulations and section 460(f) of the Code is only the threshold test for determining whether any income and expenses are attributable to long-term contract activities. To constitute a long-term contract, a contract must contain a building, installation, construction or manufacturing obligation. However, if such a qualifying obligation exists under a contract, the income and expenses that are attributable to long-term contract activities within the meaning of section 1.451-3(a)(3) are not limited to those arising only from actual building, installation, construction or manufacturing.

The regulations clearly indicate that income and expenses attributable to services are not rendered ineligible for long-term contract accounting merely because such services are not building, installation, construction, or manufacturing services. For example, for purposes of determining whether a long-term contract is an extended period long-term contract, the long-term contract activity is deemed to begin on the first date the taxpayer incurs any allocable engineering costs. See also, Section 460(c)(3)(B) (codifying this treatment with respect to long-term contracts entered into after February 28, 1986). Moreover, section 1.451-3(d)(2)(vii), example (2), indicates that the initial painting of a bridge by a contractor performing a long-term contract to construct a bridge is considered part of the contract and, therefore, must be accounted for with the remainder of the contract under the completed contract method.

Finally, section 1.451-3(d)(9)(x)(E) provides that construction or manufacturing related engineering and design expenses must be allocated to a long-term contract and deferred until completion of the contract. Thus, section 1.451-3(a)(3) contemplates that the income and expenses arising from any activity that directly benefits or is undertaken by reason of the obligation to build, install, construct, or manufacture the subject matter of a long-term contract (in the case of extended period long-term contracts), or that is incident to and necessary for the performance of such obligation (in the case of non-

extended period long-term contracts) will be accounted for under a taxpayer's method of accounting for long-term contracts.

As noted above, I.R.C. § 460 provides the method of accounting rules for long-term contracts entered into after February 28, 1986. Under section 460(c)(1), the cost allocation rules for purposes of section 460 are patterned after the cost allocation rules that apply to extended period long-term contracts as defined in section 1.451-3(b)(3) of the regulations. Thus, under section 460(c), all direct and indirect costs that directly benefit, or are incurred by reason of, the long-term contract activities of a taxpayer are allocable contract costs. The income and expenses attributable to engineering or similar services that enable a taxpayer to "construct" or "manufacture" the subject matter of a long-term contract must be accounted for as part of a long-term contract under section 460, since such services directly benefit or are performed by reason of the taxpayer's building, installation, construction, or manufacturing obligation.

A contract to provide only services that are neither building, installation, construction, nor manufacturing is not a long-term contract because such a contract does not call for the taxpayer to "build, install, construct, or manufacture" anything. Rev. Rul. 84-32, 1984-1 C.B. 129 (painting services); Rev. Rul. 82-134, 1982-2 C.B. 88 (engineering and construction management services); Rev. Rul. 80-18, 1980-1 C.B. 103 (engineering and construction management services); Rev. Rul. 70-67, 1970-1 C.B. 117 (architectural services). However, if the performance of engineering or other services enables the taxpayer to construct or manufacture the qualifying subject matter of a long-term contract, whether or not such services are specifically called for by the contract, then income and expenses attributable to such services are to be accounted for as part of the contract. Thus, services performed with respect to the building, installation, construction, or manufacturing of property by the taxpayer are properly characterized as long-term contract activities, even though, if performed alone, such services may be personal services. Moreover, even if contracted for separately by a taxpayer, engineering and construction of the same long-term contract subject matter must be integrated and accounted for as a single long-term contract, notwithstanding that the aggregation rules of section 1.451-3(e) and section 460(f)(3)(A) do not apply to a single contract involving purely services. See Treas. Reg. § 1.451-3(e)(1)(i)(B).

In the current case, the facts suggest that the [redacted] contract is purely a service contract and the [redacted] contract is a qualifying

long-term contract.[1] The facts indicate that [redacted] is merely selling a license to [redacted] to use certain [redacted] property. If the [redacted] contract is a service contract and the [redacted] contract a long-term contract, then all direct and indirect costs that directly benefit, or are incurred by reason of, the long-term [redacted] contract activities of [redacted] are allocable contract costs. [redacted]. In order to respond to your request, we would need to know exactly what [redacted] is purchasing under the [redacted] contract. Without such information [redacted].

If the facts show that the [redacted] contract is a qualifying long-term contract and not merely a contract for services, then the provisions of Treas. Reg. § 1.451-3(e) will govern the aggregation of the contracts rather than the above analysis. (See footnote 1). In this case, [redacted]

Finally, you suggest that the [redacted] and [redacted] contracts should be [redacted]." It is apparent from the above discussion that any factor which demonstrates that the costs of the [redacted] contract directly benefitted, or were incurred by reason of, the long-term [redacted] contract activities would be considered in determining whether the contracts should be aggregated. Accordingly, functional dependence may be a consideration. However, the [redacted].

As a starting point [redacted]

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[1] If both contracts were qualifying long-term contracts, then the standards that would apply in determining whether they should be treated as a single contract are set forth in Treas. Reg. § 1.451-3(e). See Notice 89-15, 89-1 C.B. 634, Q&A-37.

[redacted]. Please note, we consider the statements of law expressed in this memorandum to be significant large case advice. Therefore, we request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions regarding the above, please contact me at ([redacted]) [redacted].

[redacted]
District Counsel

By: [redacted]
Attorney

cc: Regional Counsel, [redacted]
Office of Assistant Chief Counsel, Field Service